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ANALYSIS OF CRYPTOCURRENCIES AND LEGAL FRAMEWORK FOR ANTI-MONEY LAUNDERING IN INDIA

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Abstract

Blockchain technology is a decentralized form of ledger that functions without any supervision from an external authority. The principle behind this is to reduce the cost of enforcement which is often arduous and costly for the state. It envisages a system that can maintain its integrity and transparency within itself without any regulation from a third party. Even though this technology was introduced around 1990s, it became exceedingly popular through virtual currencies such as Bitcoin which used this for creating a payment system. Through this the transactions take place in a peer-to-peer network where the information of every transaction is publicly available and it is added to the existing set of transactions in the form of blocks after the puzzle is solved by the miners.

Albeit its advantages in terms of efficiency and lower costs of monitoring, cryptocurrencies are ridden with fallacies such as its use for illicit trade, exploitation of investors and cyber-crimes. Therefore, there needs to be a balance between the autonomous nature of the technology underlying virtual currencies and the need to regulate it due to such unlawful activities. This paper focuses on a few recent case studies of scams and the Indian legal framework for anti-money laundering and its relevance to cryptocurrencies. It further emphasizes upon the legislative and judicial developments with respect to virtual currencies in the country. The research methodology adopted is doctrinal.

Introduction

The system of monetary exchange for value between people has been characterized with the need to be controlled by a third party in order to ensure that its integrity is maintained. In 2008, a paper written by Satoshi Nakamoto challenged this system because a third person regulating the

transactions would result in a higher transaction cost. His alternative was blockchain technology which is a peer-to-peer system with no financial intermediary. He highlights the flaws of entrusting the regulation of a system with a third, which does not offer a solution for double spending and states cryptographic proof as an alternative to this since people can directly transact with each other without an intermediary responsible to oversee the same.¹ Therefore, Blockchain refers to a decentralized ledger that is accessible to all the persons who use it and data is stored in a mathematical format as per the timestamps. It is a merge between computer programming and the internet that reduces the burden of enforcement.²

Among other potential uses of blockchain such as building transparent institutions in a country and enabling smart contracts, it is mostly used for cryptocurrencies. They are digital assets that are bought and sold through the virtual ledger. It is operated through a set of algorithms. The user has a private key and when it is matched with the public key on the blockchain, transactions take place. Once a transaction occurs it is permanently recorded on the Blockchain and it cannot be reversed. One other feature of cryptocurrency is that it is convertible to legal tender.³ Bitcoin and Ethereum are well known cryptocurrencies.

It is debatable whether such currencies are useful because there is no government intervention that is controlling this system of transaction in money; rather it is a peer to peer network. The tender is not issued by any financial authority. In order to aid the transaction, there are a group of people known as miners. They engage in the mathematical calculations that are necessary to verify the authenticity of a particular transaction. For their services, they are paid in Bitcoins by the community utilizing it to conduct transactions.⁴ The entire system works on the basis of trust placed on it by its users and the laws of supply and demand.

Even though there are certain advantages to Bitcoins such as security since it is hard to decipher the private key, there are certain grave risks associated with it. It is not governed by any

¹ Satoshi Nakamoto, 'Bitcoin: A peer- to-peer Electronic Cash System' (2008) Bitcoin <<https://bitcoin.org/bitcoin.pdf>>accessed 1st October 2020

² Victor Li, 'Bitcoin's Useful Backbone: Blockchain technology gains use in business, finance and contracts' (2016) Vol. 102 No. 3 American Bar Association

³ Dennis Chu, 'Broker-dealers for virtual currency: regulating cryptocurrency wallets and exchanges' (2018) 118, no. 8 Columbia law review

⁴ Stephen Middlebrook, 'Bitcoin for Merchants: Legal Considerations for Businesses Wishing to Accept Bitcoin as a form of payment' (2014) Business Law Today <https://www.americanbar.org/groups/business_law/publications/blt/2014/11/02_middlebrook/>accessed 1st October 2020

regulating authority and the lack of control makes the platform susceptible to be used for illegal activities. Since there is no physical exchange of money and entering the electronic space where the transactions take place is not easy, many transactions go unmonitored and this has implications on consumer welfare. It leads to Ponzi schemes, gateway for illicit trade in drugs and means of tax evasion. Silk Road is one such example through which was used in ordering illegal drugs or goods such as arms and ammunition through bitcoins by utilizing a proxy server. Around 30 thousand bitcoins were seized by the FBI after busting this illegal trade.⁵ The validity of this system depends on the trust that is placed by the people upon it and since it is utilized by a niche group of people there is a smaller consumer base which creates scope for illegal activities such as defrauding investors and hacking.⁶

This article focuses on some of the recent instances of money laundering through cryptocurrencies in the first part followed by the important legislations for anti-money laundering and the legislative as well as judicial developments with respect to cryptocurrencies in the second and the third parts respectively. It stresses on the need for an international model law on this issue and the importance of recognizing cryptocurrencies and regulating them as opposed to a total prohibition.

Recent case studies

Gain Bitcoin scam

GB Miners is an Indian bitcoin mining company. It was co-founded by Amit Bharadwaj with Nikunj Jain and his partner Sahil Bhagla. At that point of time, Mr. Bharadwaj owned the highest number of bitcoins owned by any individual. The objective of this company was to make the bitcoin system accessible to the average consumer by launching a bitcoin fund and a fintech development cell.⁷ In addition to this Mr. Bharadwaj also founded the Amaze Mining and Blockchain Research Ltd a mining technology firm. Pursuant to the incorporation of this company, an investment scheme known as GainBitcoin was launched. In this scheme the investors were promised a return of 10% per month in bitcoins for a period of 1.5 years. So, in the end they would be gaining a profit of about 80% over the initial money invested. However,

⁵ Misha Tsukerman, 'The block is Hot: A Survey of the State of Bitcoin Regulation and Suggestions for the Future' (2015) vol. 30 no. 4 Berkeley Technology Law Journal, 1127-1170

⁶ ibid

⁷ Rebecca Campbell, 'GB Miners Fills Gap For Bitcoin Adoption in India' (November 21st 2016) <<https://www.ccn.com/gbminers-fills-gap-bitcoin-adoption-india/>> accessed 3rd October 2020

this was a mere façade into which the investors were lured because a high return rate was promised. There was high propaganda for this investment option, until the website was closed. It is estimated that the amount swindled ranges around 2000 crores taken from eight thousand investors. Since it was done using bitcoin it became difficult to assess the exact amount.⁸

The scam came into light after multiple FIRs were filed in different cities. The investigation done by the Pune police department highlighted some clues with respect to the case. It was found that Multilevel Marketing (MLM) was used to lure investors by promising them higher returns and then the money was diverted to the international markets through siphoning.⁹ It was stated that the investors would receive returns through MCAP. MCAP lab is an entity that issues Initial Coin Offerings (ICO) which is similar to the Initial Public Offering of companies. It deals with Ethereum as the platform for cryptocurrency and the investors were promised that the returns would be paid through the MCAP tokens instead of bitcoins itself. The price determined to be paid by the MCAP token was done by Bitcoins Growth Fund which was owned by Mr. Bharadwaj. The investors were not asked to revise the terms of their contract and instead they were automatically transferred to the MCAP token system which is a breach of the contract.¹⁰

The MLM per se is not illegal, but this might lead to Pyramid Schemes which is not legal. In this the person who initiates the fraud makes only the initial payment and the other persons interested in the scheme will earn returns only if they market it and sell it to more people. Basically, it functions like a chain whereby the existing participant brings in more people to invest so that he procures a higher rate of return based on the retail sales.¹¹ This is relevant to this scam because people informed that they would be gaining additional perks if they marketed the scheme to other individuals. Through this the existing initial participants brought in their circle of family and friends to invest with the expectation of high return.

⁸ Ankit Kumar and Pankaj Khelkar, 'Cryptocurrency guru arrested for Bitcoin Based Ponzi Scheme; Scam could run into 13 Thousand Crore' (Pune, April 6th 2018) <<https://www.businesstoday.in/current/corporate/cryptocurrency-guru-arrested-for-bitcoin-ponzi-schemes-scam-could-run-into-rs-13000-crore/story/274255.html>> accessed 3rd October 2020

⁹ Shaurya Malwa, 'Indian Police Find Crucial Clues in \$300 Million Gain Bitcoin Scam' (July 15th 2018) <<https://www.ccn.com/indian-police-find-crucial-clues-in-300-million-gain-bitcoin-scam/>> accessed 3rd October 2020

¹⁰ Aria Thaker, 'Two Sides of the Same Coin: Amit Bhardwaj's Cryptocurrency for Beginners Is a Poorly Written Instrument of his Shady Business' (12th August 2017) <<https://caravanmagazine.in/vantage/amit-bhardwaj-book-gain-bitcoin-shady-business-schemes>> accessed 3rd October 2020

¹¹ <<https://www.fic.gov.za/CaseStudies/Case%20Studies/Pyramid%20Scheme.pdf>> accessed 3rd October 2020

Bitconnect scam

A US based company known as Bitconnect launched cryptocurrency called the Bitconnect coin (BCC) in 2017. Through this investors could loan a part of their money to the company and earn an interest of about 40% per month. They used broad market strategies to induce the investors to lend money and after a period of time, the scheme was stopped and the value of the coin fell by 96%.¹² The scheme also stated that they would receive a daily profit based on the market volatility through which they can earn their capital back and invest this in the same scheme. The interest rates were fixed by backend volatility software. Another component of their scheme was the BCC staking program. In this the investors had to buy BCC and deposit the same in a wallet created known as the Bitconnect-QT software and within fifteen days they would be given interest depending upon the duration for which their money was deposited in the wallet itself. In addition to this, there was a third scheme as well through which the investors could refer to these schemes and if another person invests through this referral they will get an interest from the money invested by this person. Essentially this was a pyramid scheme similar to the previous case. The scheme was also marketed through various social media platforms with attractive captions indicating at earning quick money to live a lavish lifestyle.¹³ This was a Ponzi scheme, that did not invest the money received but rather used it to pay the interest of future investors. Moreover, the administrators could not trace the source of these schemes because it was cleverly conducted completely anonymously.¹⁴

These schemes were not registered with the Security Exchange Commission for obvious reasons. However, the court stated that in order to decide whether an instrument is a security or not it is necessary to focus on the 'economic realities underlying the transaction' and in this case the investors deposited their fiat currency with the BCC in anticipation of higher returns. Therefore, they were investment contracts.¹⁵ It was also concluded by the court that the defendants are 'sellers' within the meaning of securities laws since they endorsed the scheme to various

¹² Cárdenas-Rodríguez and others, 'Cryptocurrency Scams' (Conference CLADS XVI, Puebla México 2018)

¹³ In re Bitconnect Securities Litigation 9:18-cv-80086-DMM

<http://securities.stanford.edu/filings-documents/1064/B00_01/201873_r01c_18CV80086.pdf> accessed on 5th October 2020

¹⁴ Stafford Baum, 'Cryptocurrency Fraud: A Look Into The Frontier of Fraud' (2018) University Honors Program Theses <<https://digitalcommons.georgiasouthern.edu/honors-theses/375>> accessed on 5th October 2020

¹⁵ Stafford Baum, 'Cryptocurrency Fraud: A Look into the Frontier of Fraud' 28-29

investors through social media platforms such as YouTube in anticipation of higher returns. Many of these defendants had high numbers of subscribers on YouTube and through their promotions many people from the public decided to invest in the scheme. The court noted that YouTube had not taken reasonable care to review the content that was displayed on its platform and the algorithm failed to trace such hoax videos that provided misinformation to the public about a Ponzi scheme as a legitimate investment opportunity.¹⁶ The district court of Florida concluded in its Judgement that the defendants had violated the security laws and they had engaged in fraudulent misrepresentation that was against the Deceptive and Unfair Trade Practices Act and that the Plaintiffs must be provided with equitable relief through compensation and an order for the recession of investment program was passed.

The common characteristics in these recent scams involve extensive marketing tactics that lure potential investors expecting high short term gains. However, such scams in cryptocurrencies can occur due to other third party intermediaries as well. An example of this could be the Poloniex scam wherein the latter is one of the largest bitcoin exchanges and a hack was executed and an app was released by a third party in the form of a wallet to simplify the use of this exchange.¹⁷ Through this 12.3% of the Bitcoins was stolen in 2014 from the investor who opted to install this application.¹⁸ Another instance is the German Karat Gold Coin, which was the first of its kind to create a platform for the exchange between physical gold and tokens issued which were digital currencies, facilitated by blockchain technology.¹⁹ However, there have been allegations that it was a pyramid scheme and its authenticity has been in dispute.²⁰ These case studies raise questions about the degree of awareness within the consumers as well, in addition to oversight by the administration.

¹⁶ Ibid 35-37

¹⁷ Pengcheng Xia and others, 'Characterizing Cryptocurrency Exchange Scams' (16th March 2020)
<<https://arxiv.org/pdf/2003.07314.pdf>> accessed on 7th October 2020

¹⁸ Mauro Conti and others, 'A Survey on Security and Privacy Issues of Bitcoin' (25th December 2017)
<<https://arxiv.org/pdf/1706.00916.pdf>> accessed on 7th October 2020

¹⁹ 'KaratGold Coin (KBC) is a Cryptocurrency With a Special Extra Feature' (14th May 2019)
<https://cdn-cms.f-static.net/uploads/2326656/normal_5d30d0f8caea3.pdf> accessed on 8th October 2020

²⁰ 'German Firm told to Wind Up Cryptocoin Business after Pyramid Scheme Claims' (December 2019)
<<https://www.theguardian.com/technology/2019/nov/13/german-firm-told-to-wind-up-cryptocoin-business-after-pyramid-scheme-allegations>> accessed on 8th October 2020

Legal provisions

Indian Penal Code

The Indian Penal Code (IPC) that was enacted in 1860 is the general law pertaining to criminal cases. Sections 415 to 420 of the Code provide provisions with respect to 'Cheating.' The basic elements of cheating are intentionally or fraudulently inducing a person to do or to omit something which he would otherwise not engage in but for the deception, which ultimately leads to the loss of the individual so deceived. The requirement of intention to induce a person who ultimately results in his detriment is essential to fulfill the requirements of these provisions. Fraud is covered under Sections 421 to 424 of the statute. There is an element of difference between cheating and fraud. The latter is with reference to 'criminal breach of trust' which is a more serious offence and there exists an element of unjust enrichment in fraud where in addition to the loss suffered by the person who is wronged, the person who commits it also gains at their expense which is not always applicable in the case of cheating.

Sections 120A and 120B state the definition for criminal conspiracy and punishment respectively. It occurs when two or more persons engage in an illegal act or a legal act through illegal means by engaging in an agreement towards the same. This is when two or more persons have a premeditated intention to commit an offence and they engage in an act towards the same. The above cases of misappropriating investor's money through bitcoins fall under the ambit of fraud because there is criminal breach of trust. The accused gained the trust of many consumers situated at different parts of the country and marketed the scheme. Since there were other partners in addition to the main accused who participated in consensus with the plan, there also exists a situation of criminal conspiracy.

IPC is a general law and the incidences of money laundering were rapidly increasing, a need was realized to enact a special statute to streamline the adjudication of these cases. Therefore, the Prevention of Money Laundering Act was enacted.

Prevention of Money Laundering Act (PMLA)

It was enacted in the year 2002 and it is a special legislation with respect to such cases. The objective of the Act states that it is for the purpose of preventing money laundering and to seize the property that has been derived from such means. Section 3 defines money-laundering as, Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money-laundering.

The term 'proceeds of crime' is defined under Section 2(u) as a property that is obtained from a criminal activity which is a scheduled offence, directly or indirectly. Section 4 of the Act prescribed the punishment as rigorous imprisonment not less than three years but which might extend to seven years and fine. Section 5 of the act states the procedure for attachment of property that is involved in money-laundering by the Enforcement Directorate. After the scheduled offence is reported to the magistrate and a complaint is filed with the appropriate authority, the director or deputy director can attach the property if it is found that it constitutes proceeds of crime and that it will be further misappropriated.

The statute provides for authorities which are independent to investigate the offence. After the complaint is filed under Section 5, the reports in that regard are to be put forth before the adjudicating authority whose powers and functions are provided under Section 6. The authority is appointed by the central government and it constitutes a chairman and two members. They are not bound by the Civil Procedure Code, but they are guided by the principles of natural justice. Under Section 8, the authority has the power to conduct trial by providing opportunity for the party to show cause. If it is proved that the property is proceeds of crime then decision made by the director will be confirmed. The property is vested with the central government after it is seized free of all encumbrances and an administrator is appointed under Section 10 to manage the property. If the property must be retained beyond a period of 180 days, the authority must satisfy itself that a prima facie case must be made out as per Section 20. Once the property is seized there is a presumption that the case of money-laundering is made out and the burden of proof is upon the accused to prove otherwise.

As per Section 25, if any of the party is not satisfied with the decision given by the adjudicating authority then an appeal can be filed with the appellate authority within a period of forty-five days and if sufficient cause is shown. Further appeal from the appellate authority lies to the High

Court within 60 days of the order. The trial is conducted according to the procedures prescribed in CrPc. The Schedule of the statute prescribes the offences under other legislations such as IPC, Narcotic Drugs and Psychotropic Substances Act, Explosives Act, Information technology Act among others. The specific offences under these legislations that are provided within the schedule are regarded as scheduled offences.

The Finance Act of 2019 has amended certain provisions of PMLA. There existed a sense of ambiguity in interpreting the terms 'proceeds of crime' since it referred only to the scheduled offence. Through the amendment it includes any property which might be directly or indirectly obtained as a result of a criminal activity though not provided under the schedule.²¹ The ambit of the term is increased to include not only a one time offence but even when it is utilized for a period of time making it a continuing offence. The powers of ED have been broadened and an arrest can be made without a warrant from the court or an FIR.²² The extension of proceeds of crime to non-Schedule offences is advantageous since it can cover frauds that are non-conventional such as those done through Cryptocurrencies.

Foreign Exchange Management Act (FEMA)

The FEMA Act of 1999 was enacted with the objective of regulating foreign exchange market and to consolidate as well as amend the laws relating to foreign exchange for facilitating international trade.²³ Under Section 36 of the Act, the Enforcement Directorate is established by the Central Government. Section 37 of the Act provides for the powers of search and seizure in the event of contravention of provisions of the Act and these powers are similar to those accorded to the Income Tax Authorities under the Income Tax Act of 1961.

Under Chapter 3 of the Act, the RBI can certify certain persons as 'authorized persons' and only such persons are permitted to deal with foreign exchange or securities. Such permission is given by the RBI with certain conditions such as requirement of compliance with the rules and disclosure of information as stipulated by the RBI.

²¹ AZB & Partners, 'India: Amendments to the PMLA made by the Finance Act 2019' (16th December 2019) <<https://www.mondaq.com/india/money-laundering/857752/amendments-to-the-pmla-made-by-the-finance-act-2019>> accessed on 8th October 2020

²² Faraz Alam Sagar and Pragati Sharma, 'PMLA Amendment 2019- Plugging the Loopholes' (18th September 2019) <<https://corporate.cyrilamarchandblogs.com/2019/09/finance-act-2019-prevention-money-laundering-act-amendment/>> accessed on 8th October 2020

²³ 'Foreign Exchange Management Act, 1999' <http://legislative.gov.in/sites/default/files/A1999-42_0.pdf> accessed on 8th October 2020

Under Section 3 of the Act, there is a prohibition on non-authorized persons from dealing with foreign exchange and Section 4 prohibits the holding, transfer, ownership or possession of any immovable property or foreign exchange or security situated outside India. If there occurs a violation of Section 4, the authorized officer has the power according to Section 37A to seize the value equivalent to the foreign exchange or asset which is situated within India, provided the value of the property exceeds the threshold prescribed. The reasons for such seizure must be recorded and it must be produced before the competent authority within a period of thirty days from the date of such seizure. The competent authority must dispose of this within 180 days after ensuring that adequate representation is given to the directorate and the aggrieved person.

Section 13(1) (B) provides that the Adjudicating Authority or the Enforcement Directorate can file a criminal complaint post recording the reasons for the same. If a person has acquired immovable property outside India and the value of such property exceeds the prescribed threshold, then in addition to the penalty, an imprisonment for a term of five years with fine is imposed.

This legislation plays an important role because the crime of money laundering is no longer confined to a particular country, rather it is organized internationally. The first stage of the process usually involves the deposit of illicit cash to multiple accounts in different jurisdictions because the countries have varying thresholds above which the transaction would be investigated. Post this the funds are usually moved towards the illicit objective for which it was accumulated through complex transactions and the possibility of this in multiple countries further enables in obscuring the reality of the source of money. The returns achieved from this are usually inserted back to the economy through transactions that are legal and this can be done through investments.²⁴ Cryptocurrency proves to be a convenient system of transacting money for such purposes since the requirements for its functioning are computers and the internet which have no geographic boundaries. The only territorial element that is relevant is the laws of a particular country that does not recognize such currencies as legal. However, this does not prevent people from utilizing it for purposes such as money laundering since non-recognition leaves this channel of transacting money in vacuum which is then exploited for such purposes.

²⁴ Christine Jojarth, *Money Laundering: Motives, Methods, Impact, and Countermeasures in Transnational Organized Crime: Analyses of a Global Challenge to Democracy* (Bielefeld: Transcript Verlag, 2013)

SEBI Guidelines on Anti-Money Laundering Standards (AML) and Standards of Combating Financial Terrorism (CFT)

This directive is with respect to the intermediaries in the stock market under Section 12 of the Securities and Exchange Board of India Act of 1992. This states that a prerequisite for an intermediary such as a stock broker, share transfer agent, merchant banker or underwriter to buy and sell securities is to ensure that registration is granted by SEBI. Venture capital schemes and collective investment schemes also require permission from the board as per the regulations.²⁵

The violation of Section 12 is categorized as a schedule offence in the PMLA and the above directives provide practical implications about this and further clarity about the responsibility of intermediaries in order to prevent money laundering. It prescribes a set of compliance requirements by the intermediaries for reducing the crimes of money laundering and financial terrorism.²⁶

The registered intermediary is required to undertake the 'Client Due Diligence' process in order to assess their client's source of money and any inconsistency must duly be reported to the authorities for further investigation. These intermediaries must also prescribe certain standards and requirements before accepting a particular client with the objective of verifying the identity of the clients and to reduce fictitious transactions.²⁷ It states that assessment of clients must be done on the basis of the risk assessment and accordingly the compliance must be adhered to. This means that background information must be recorded as prescribed which can be asked to be produced for further verification by the board. Any suspicious clients or transactions noted by the intermediary must be reported to the Director of the Financial Intelligence Unit. The intermediary must also appoint designated directors and principal officers whose responsibility it is to ensure the compliance of this directive.²⁸

The obvious question that arises is with respect to the interconnection between stock market and cryptocurrencies. A parallel can be drawn between the two systems because similar to the intermediaries in the stock market, there are digital wallets. They perform functions that coincide

²⁵ 'The Securities Exchange Board of India Act, 1992'
< <https://www.sebi.gov.in/acts/act15ac.pdf> > accessed on 10th October 2020

²⁶ 'Guidelines on AML standards and CFT' (4th July 2018)
< https://www.sebi.gov.in/legal/master-circulars/jul-2018/guidelines-on-anti-money-laundering-aml-standards-and-combating-the-financing-of-terrorism-cft-obligations-of-securities-market-intermediaries-under-the-prevention-of-money-laundering-act-2002-a-_39431.html > accessed on 10th October 2020

²⁷ Ibid

²⁸ Ibid

with that of the intermediaries such as being custodians of the investor's money and to engage in its trading. A common thread is the protection of the interests of investors or customers who entrust their money in the hands of the intermediaries or wallets. The scenarios of mismanagement that have the possibility of occurring also have overlap.²⁹ In addition to this, foreign investments by way of securities is a cumbersome process when compared to purchasing bitcoins which is inherently global in nature and this might result in potential investors with high risk tolerance to shift to bitcoins.

Further understanding with respect to this is to evaluate whether the definition of securities as per Section 2(h) under the Securities Contract Regulation Act of 1956 includes cryptocurrencies within its ambit.³⁰ It is not covered within the ambit of securities because an essential element of its definition is that it must be marketable in any of the recognized stock exchanges and since virtual currencies are transacted on a different platform it is excluded. However, as discussed previously the returns received through money laundering of cryptocurrencies can be invested in the mainstream market through investments in securities. It can also come within the ambit of securities if the virtual currencies are offered as a part of exchange for commercial transactions such as the commodities market.³¹

Reserve Bank of India (RBI)

The RBI is the financial regulator in the country and it imposed a ban upon virtual currencies on April 6th 2018 by cautioning the users of virtual currencies about the risks associated with it. The circular stated that all regulated entities must refrain from any dealings in virtual currencies and if they are already engaged in such business they must exit from it within a period of three months.³² This prohibition resulted in complete separation between virtual currencies and fiat currencies whose value is maintained by the government. The implication of this is that the

²⁹ Dennis Chu, 'Broker-Dealers for Virtual Currency: Regulating Cryptocurrency Wallets and Exchanges' (2018)118,no.8 Columbia Law Review

³⁰ Rahul J Nikam, 'Model Draft Regulation on Cryptocurrency in India' (2018) Vol.4 Issue2 Hasanuddin Law Review 146-161

³¹ *ibid*

³² RBI, 'Prohibition on Dealing with Virtual Currencies' (6th April 2018)
<<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>> accessed on 10th October 2020

cryptocurrencies cannot be converted to Indian rupees, however the vice versa and trading between cryptocurrencies is still possible.³³

The Payment and Settlement Systems Act was enacted in the year 2007. The objective of this legislation is to provide powers to the RBI for the regulation and supervision of the payment systems in India. The definition of payment system is given under Section 2(i) to mean

A system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them, but does not include a stock exchange. It also includes any payment made through credit card, debit card, money transfer operations or similar operations³⁴.

Section 2(c) of the Act defines 'Electronic funds Transfer' as to include authorization made to a bank to debit or credit an account that is maintained by the bank through automated teller machines, telephone, internet or card payment. As the objective of the Act itself states, RBI is the monitoring authority and as per Section 4 no payment system can function without receiving a prior authorization from RBI. Once the application is submitted the genuineness of this is assessed by the RBI. According to Section 9, if the authorization is not given due to any specific reason after the applicant has been heard, then he has the right to appeal to the central government within thirty days and this application must be endeavored to be disposed of within three months. The Act further provides that the RBI has the powers to monitor the functioning of these payment systems by requiring them to adhere to the compliance standards such as conducting regular audits and providing information as required. RBI can also frame policies and regulations as per the changing needs to regulate electronic and non-electronic payment systems in order to safeguard public interest.

The relevance of this statute to cryptocurrencies is that it recognizes the electronic mode of payment system. The definitions of payment system and electronic funds transfer are indicative of this. These terms are defined broadly under the statute and it also includes transactions that are done through the internet. However, the legislation does not extend to cryptocurrencies because it is necessary for the payment system to obtain authorization from RBI in order to be considered

³³Vaibhav Parikh and Others, 'India' (2018) The Virtual Currency Regulation Review
<http://www.nishithdesai.com/fileadmin/user_upload/pdfs/NDA%20In%20The%20Media/News%20Articles/181207_A_The-Virtual-Currency-Regulation-Review-India.pdf > accessed on 10th October 2020

³⁴ 'The Payments and Settlement Systems Act, 2007
<<https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/86706.pdf> >accessed on 10th October 2020

as legal and valid in the country. However, with the pretext of the circular issued by the regulatory authority, it becomes clear that the entire system of virtual currencies is considered to be illegal and it has no scope for being authorized under this statute.

In the annual report released by RBI in 2017-18 observed the increasing trends in the use of cryptocurrencies for money laundering, frauds and financial terrorism. It states that a 'globally interconnected approach' is necessary to prevent such activities. The report provides the example of the United States where the Securities Exchange Commission and the Commodities Futures Trading Commission regulate cryptocurrencies as well.³⁵ However, in India the step taken towards virtual currencies is the imposition of ban upon it.

Legislative Developments

On 28th February 2018, the inter-ministerial committee released a report titled 'Specific Actions to be Taken In Relation To Virtual Currencies' released by the Ministry of Finance.³⁶ The report begins with the relevance of Distributed Ledger Technologies (DLT) and it states that this technology is still at a developing stage. Since there is ambiguity about the jurisdiction, it becomes complicated to regulate.

Chapter two discusses the virtual currencies and its development in terms of the increase in Initial Coin Offerings (ICO) adopted by startups through tokens that amounts to as much as 20 billion USD as of 2018. However, it emphasizes upon the volatility of this system even though it can improve its efficiency. It elaborates that,

The market potential of these functionalities is subject to technological and behavioral changes, as well as the scope of financial investment that the cryptocurrencies can raise. All these factors make the intrinsic value of cryptocurrencies negligible, and subject to severe shocks or fluctuations.³⁷

The concerns about the fact that a transaction once completed cannot be reversed and the anonymity of the identity of the users of cryptocurrencies that leads to information asymmetry and ambiguity about the transaction are also the reasons mentioned in the report.

³⁵ RBI Annual Report 2017-18 48-49

<<https://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/0ANREPORT201718077745EC9A874DB38C991F580ED14242.PDF>> accessed on 11th October 2020

³⁶ Report of the Committee to Propose Specific Actions to be taken in Relation to Virtual Currencies (28th November 2019)

<<https://dea.gov.in/sites/default/files/Approved%20and%20Signed%20Report%20and%20Bill%20of%20IMC%20on%20VCs%2028%20Feb%202019.pdf>> accessed on 11th October 2020

³⁷ Ibid 27

The analysis of the status of virtual currencies in different countries is provided for a better understanding of the international perspective. In countries such as Russia and Canada Virtual Currencies are allowed for barter transactions and as a mode of payment for goods and services, but it must comply with the disclosure requirements. In Switzerland, it is allowed as a mode of payment but only at the option of the receiving party who is not obligated to receive bitcoins instead of the fiat currency. It is recognized as digital assets and it is permitted so long as it is not violating the anti-money laundering laws. In China there is a complete ban imposed and a firewall is created to prevent access to cryptocurrencies. An interesting observation made was that no country recognizes this as a part of the legal tender.³⁸ The recommendation of the committee was that 'all private cryptocurrencies, except any cryptocurrency issued by the state, be banned in India' and criminalize the same by furthering the stance taken by RBI.³⁹

Pursuant to this, a bill for Banning of Cryptocurrency and Regulation of Official Digital Currency was introduced in the parliament in 2019. The preamble of the bill is, 'An Act to prohibit the use of Cryptocurrency, regulate the Official Digital Currencies and for matters connected therewith or incidental thereto'.⁴⁰ The definition of cryptocurrency under Section 2(1) (a) states that it is any such information, token, currency or representation of currency in digital format which is transacted with or without consideration. It involves a risk or potential of profit or loss for the holder, and can be utilized for the purpose of any investment. It is any such digital information that is not officially recognized by the government. Digital rupee is defined under Section 2(1)(d) to mean the currencies that are issued by the RBI and have received the approval of the Central Government. Section 3 places a general prohibition that 'no person shall mine, generate, hold, sell, deal in, issue, transfer, dispose of or use cryptocurrency in the territory of India.'

Section 8(1) provides that an imprisonment of one year to ten years can be imposed if a person is convicted. As per Section 8(3) if a person is involved indirectly in the promotion or advertisement of cryptocurrency and involves in the act of inducing and abetting the use of such currency is punished for an imprisonment for a term which may extend up to seven years with

³⁸ Ibid 23-27

³⁹ Ibid 34-35

⁴⁰ Banning of Cryptocurrency and Regulation of Official Digital Currency Bill, 2019
<https://www.prsindia.org/sites/default/files/bill_files/Draft%20Banning%20of%20Cryptocurrency%20%26%20Regulation%20of%20Official%20Digital%20Currency%20Bill%2C%202019.pdf> accessed on 11th October 2020

fine. Section 11 Investigating Authority is to be appointed to examine such cases in accordance with the procedure established under Criminal Procedure Code. Schedule two provides that the second schedule to the PMLA must be amended so as to include para 30 to integrate section 8 of this statute and anti-money laundering.⁴¹

Supreme Court

In the recent case of Internet and Mobile association vs RBI (Writ Petition Nos 528 and 373 of 2018, decided on 4th March 2020), the court deliberated upon the legality of the ban on virtual currencies imposed by RBI in its circular in 2018.⁴² The contention of the petitioner was that RBI does not have the locus standi to bring in such a regulation since it does not fall within the purview of the RBI Act of 1934 or the Banking Regulation Act of 1949. Further, since virtual currencies are not recognized, it does not fall within the ambit of credit or currency system and hence it is beyond its purview. The arguments further highlight the fallacies in RBIs stance because it has accepted that such a system is efficient and it has also recognized the importance of block chain technology, but yet imposed a ban on cryptocurrencies which function on this technology itself. The petitioners stated that RBI has not recognized the fact that they are genuine users of this system of payment and they follow all the requisite compliance requirements by engaging in transactions that are limited to India. Hence, they asserted that cryptocurrencies need not always be anonymous in nature. The basis of their contention was that this subordinate legislation violated the right to carry on trade under Article 19(1)(g) of the constitution.

The counter arguments by RBI were that such virtual currencies do not satisfy the requirements of a currency and it has the potential to disturb the monetary stability of the country. Further, they are no recourse to consumer grievances. Pseudo-anonymity raises questions about the source of the income and the nature of the transaction. The regulations were imposed based on the wide powers given to RBI under the statutes. The right to trade given under Article 19(1) (g) of the constitution can be reasonably restricted based upon public interest.

⁴¹ Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019
< <https://www.prsindia.org/billtrack/draft-banning-cryptocurrency-regulation-official-digital-currency-bill-2019>>
accessed on 11th October 2020

⁴² *Internet and Mobile association vs RBI* Writ Petition Nos 528 and 373 of 2018
<https://main.sci.gov.in/supremecourt/2018/19230/19230_2018_4_1501_21151_Judgement_04-Mar-2020.pdf>
accessed on 11th October 2020

In the first part of the judgement, the Supreme Court traces the origin of RBI and the powers granted to it under the RBI Act. Section 45 of this Act provides the power for RBI to make policies, control the monetary and credit system of the country 'to its advantage' and it was interpreted by the court that this includes the authority to make regulations and provide directions with regards to this. Section 5 and 21 of the Banking Regulation Act which deal with formulation of banking policy by RBI in the interest of the financial system and the policy to be followed by the banking companies in public interest and the interest of the depositors respectively clearly states that RBI has such authority. Therefore, it was stated that the RBI has been conferred with various powers under these statutes to evaluate the risks associated with the participants of the system.

The subsequent part of the judgement focuses upon the identity of virtual currencies and the court tries to narrow down its scope for a better clarity. After giving due consideration to the definitions adopted by international organizations and various countries around the world, the court came to the conclusion that though virtual currencies are not recognized to be legal tender they still depict value and can function as a medium of exchange and hence they fulfill the requirements of a currency. The court emphasized that RBI did not look beyond the physical features of cryptocurrencies to evaluate its value and it could've included this within the purview of Section 2(h) of the FEMA Act which defines currency under the phrase 'other similar instruments'. The court draws a parallel to other instruments such as cheques and promissory notes which are not currency in the literal sense, but they still perform the function of discharging monetary obligations.

Though the court observed that that total prohibition is restrictive, it observed that the circular issued by RBI is only directive in nature for the entities involved in the banking channel, but this does not affect the virtual currency transactions outside the banking channel. The circular is not synonymous to complete prohibition. The court differentiated between the use of cryptocurrency for the sole purpose of buying and selling and its use for the purpose of business such as providing an online platform for convenient transactions. The former who buy and sell cryptocurrency as a matter of hobby or to make profits just by engaging in transactions have no locus standi, but the latter who engage in it for the purpose of trade can raise this issue as a restriction on their right. The court brought in the rule of proportionality which seeks to balance the intention of the legislature and the right that is infringed by the statute. It is stated that RBI

could not show any proof about the damage that is caused to the mainstream banking sector due to virtual currencies. Even though the RBI's circular does not impose a complete ban, the 2019 bill mandates this. Hence, it was held that it is against the principle of proportionality due to the contradiction between the stance of RBI when it says it has not banned the cryptocurrency completely and the 2019 bill whose objective is to impose a blanket restriction.

The major outcomes derived from this judgement is that even though RBI has the powers to legislate and pass directives with respect to virtual currency, it cannot usurp the principle of proportionality and infringe the right to trade as per the constitution. The court also negatives the stance of RBI that these currencies are not capable of holding value because the concept of money has undergone a change over the years and due to developments in technology there are newer modes of payments and transactions.

Conclusion

There has always existed a murky ground about the legality of cryptocurrencies. There is no uniform international consensus with regards to this system of payment and countries have adopted various policy measures that suit their respective structures of economy and socio-political views. This has resulted in no model international law upon this subject. This is despite the fact that the nature of virtual currencies is itself beyond borders. The major challenge towards developing a model law is the difficulty in achieving consensus between the member nations and in order to achieve this various regulatory or non-regulatory mechanisms adopted by different countries must be reconciled and a middle ground must be negotiated. A model law will enable a broad framework of principles that such a system must be obligated to follow in order to prevent money laundering.

One might argue that this would be against the basic concept of virtual currencies because the principle behind it is trust within the system and dependence on the miners and blockchain technology, without any intervention in order to ensure that the transactions are genuine. But, this has proved to have adversely affected the potential use of this technology itself because it is being utilized for illegal activities. Since the technology underlying the system is per se useful in reducing transaction cost and increasing efficiency, its objective can be achieved only if the benefits of advantages exceeds the cost of misuse which is increasing. This is possible only with transparency, compliance requirements and mandatory obligations. An international framework for this purpose will provide guidelines towards this and it will also be a step towards uniformity.

In India, there is a contradiction between the stance taken by the Supreme Court and legislature and in an era of rapid changes this will prove to be a difficult situation since it will result in a delay in tracing and investigating instances of scams. The apex court is right when it states that a complete ban on virtual currencies is against the principle of proportionality because it is capable of being a store of value like any other currencies and there are legitimate users as well as businesses that engage in such investments. Moreover, a complete prohibition will not solve the issue because scams and money laundering can still occur in the hindsight which will impact the investors adversely. Therefore, the 2019 bill must be re-evaluated pertaining to certain provisions. The bill does not delve into the various types of cryptocurrencies and the difference between them which is important for effective regulation. It states that the 'investigating authority' must be appointed to investigate the scams. This is vague because there is no specific authority that is given the responsibility. An alternative would be to bring in the Enforcement Directorate as the investigating authority within this statute since they perform similar functions. In addition to this, as the bill has already been included in the Schedule of PMLA, the machinery established under this act to conduct the proceedings of the accused can be utilized for the purposes of the offenders under the bill as well. It is also necessary to integrate FEMA Act and the 2019 bill since this will enable in understanding the ambit of the term cryptocurrency.

One of the important issues with respect to virtual currencies such as Bitcoin is the pseudo-anonymity of the users. This is a hurdle since the source of the money becomes a difficult task to trace. Hence, policies must focus on making rules related to the disclosure of information so that the users can be identified. Even though miners play an important role in solving mathematical computations for ascertaining the genuineness of the transactions, it is necessary to set ethical standards for their functioning for preventing monopolizing of the mining power and undue maximization of private gain.

The regulation of cryptocurrency in an isolated manner will be complex for the purpose of enforcement since these cryptocurrencies can be used in exchange of commodities and fiat currencies. The stance taken by RBI that there must be no dealings with cryptocurrency by the banking channels regulated by it will create additional problems since such transactions can still take place, but be unnoticed. The recognition of the interaction between the mainstream payment system and cryptocurrencies is a prerequisite for effective regulation and timely check on illegal activities. The major objective of anti-money laundering laws is the protection of interests of

investors and consumers so as to channelize money for economic development. The huge amount of money involved in cryptocurrencies cannot be protected or used for productive purposes if a ban is imposed. Hence, it is necessary to understand the peculiarities of this payment system and frame statutes that aid in bridging the information asymmetry that is associated with the objective of protecting the investors and prevent hold up of money within it.



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